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The Importance of State Rainy Day Funds

The Kentucky Budget Reserve Trust Fund

EXECUTIVE SUMMARY

Kentucky has been diligent over the last decade to build the Budget Reserve Trust Fund to its historically largest level in FY2001. However, the fund needed to be used to address budget shortfalls in both FY2001 and FY2002. The Budget Reserve Trust Fund is important for Kentucky for the following reasons:

- 1) Rainy Day Funds provide a formal plan for dealing with revenue shortfalls rather than requiring ad hoc methods such as across the board appropriation cuts, delays in spending, or deferrals of obligations. Rainy Day Funds do not take the place of budgetary discipline, rather they provide the time necessary to make reasoned choices.
- 2) A Rainy Day Fund helps reduce the interest the state pays on its bond issues. Bond rating agencies consider states with effective mechanisms for building financial reserves to be exhibiting fiscal discipline and preparedness for dealing with economic downturns.
- 3) A Rainy Day Fund may also serve as an automatic economic stabilizer. Revenues can be deposited into the fund during periods of strong economic growth and re-injected into the economy when an economic downturn causes revenues to lag.

POLICY RECOMMENDATIONS

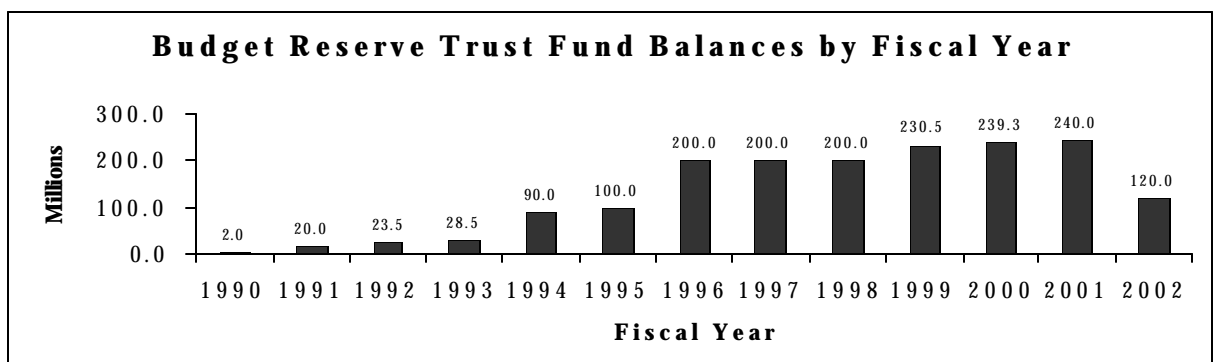
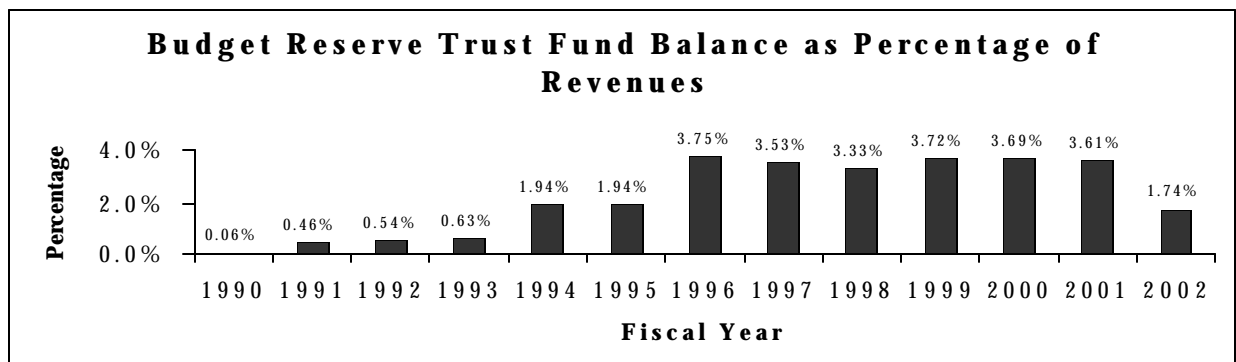
- 1) Any transfers made from the Budget Reserve Trust Fund to facilitate cash flow should be repaid as soon as possible. The use of Rainy Day Funds by states in times of economic downturns is not viewed negatively by the bond rating agencies if the funds are replaced.
- 2) The Commonwealth must develop a credible strategy for replenishing the Budget Reserve Trust Fund.
- 3) Kentucky Revised Statute (KRS) 48.705 should be amended so as to remove the five percent limit currently in place on the size of the Budget Reserve Trust Fund.

INTRODUCTION

States have always faced the problem that when the economy weakens and revenues decline, the demand for services may in fact increase, forcing governments to cut other services and/or raise taxes. Many states experienced this plight in the eighties and early nineties. Coupled with many states' citizens' rejection of property taxes as the major source of funding for schools and local governments, many states face a situation where they do not have the tax diversification needed to mitigate the risks posed by an economic downturn.

Over the past two decades, nearly all of the states have developed and implemented Rainy Day Funds, called the Budget Reserve Trust Fund here in Kentucky and "Budget Stabilization Funds" in many other states. Thirty-nine states have created this fund by statute vs. Constitution. All states have structured their funds as to provide state governments a management tool to stabilize public spending by covering shortfalls during times of recession and to increase their reserves during economic expansions. It is important to note, however, that they were never intended to replace thoughtful fiscal policy. The funds should be accessible but must have tough standards to avoid being used as a slush fund. The intent of rainy day funds is not to pay for new programs, no matter how worthy. It is, rather, to sustain and salvage good programs, which are already in place when bad times occur. States tend to view their year end general fund balances as available on a short-term basis to meet unforeseen needs and a budget reserve fund balance as a longer-term strategic source of reserve funds.

Kentucky has, by KRS 48.705, set a goal of maintaining a Budget Reserve Trust Fund (BRTF) balance of approximately five percent of annual General Fund revenues. This is a common standard among states and is endorsed by the National Conference of State Legislatures and the National Association of State Budget Officers. Formally established in 1987, Kentucky's Budget Reserve Trust Fund has increased by more than \$250 million since its incep-



Source: FY 1990-2000, Actual; [Kentucky Financial Report](#); FY 2001, Office of State Budget Director; FY 2002, June 19, 2001 Consensus Forecast Group

Note: Revenues for FY 2000-2002 do not include tobacco receipts from the Master Settlement Agreement (MSA).

tion. In FY2001, the Budget Reserve Trust Fund had a balance of \$278.6 million, which was approximately 4.0 percent of revenues. This is comparable to the national average of 4.3 percent. (Note Attachment 1)

Kentucky experienced a revenue shortfall of \$159.4 million in FY2001. Pursuant to the Budget Reduction Plan included in House Bill 502 of the 2000 General Assembly, \$38.8 million was taken from the Budget Reserve Trust Fund to address the budget shortfall in FY2001. At the date of this writing, it is officially projected that the Commonwealth will experience a budget shortfall in FY2002 of \$326 million. Again, pursuant to the Budget Reduction Plan included in the Appropriations Act, the Commonwealth will utilize \$120 million, the maximum amount allowed to be used without additional legislative authorization in FY2002. These actions result in a Budget Reserve Trust Fund balance of \$120 million or 1.74% of the revised General Fund Revenues for FY2002.

BOND RATING AGENCY VIEW OF RAINY DAY FUNDS

The major bond rating agencies (Standard & Poor's, Moody's Investor Service, and Fitch) assign a rating of credit quality to the bonds issued by the state. Because of the wide acceptance in the credit markets of bond rating as a proxy for an issuers' willingness and ability to repay borrowings, a higher bond rating reduces the interest rate the borrower has to pay. States' financial advantage of issuing tax-exempt bonds for government projects and programs can be significantly enhanced by higher bond ratings.

The bond rating companies are especially interested in how states manage their financial affairs, including how they handle future contingencies related to economic growth and recession or slowdowns in the economy. Such slowing periods have an adverse impact on state revenues, and these recessionary periods are of differing severity and the effects of which vary from state to state. The bond rating companies look to see if there are revenue balances or reserves, which could be called upon in the event of revenue shortfalls. The ending general fund balance and a rainy day fund are the most common forms of available monies to meet an issuer's contingencies.

With all but four states having established a rainy day fund, the major bond rating agencies have all begun using a state's rainy day fund as an important criterion for assessing the credit worthiness of bond issues. As these bond issues are authorized for the funding of major projects and investments, a strong credit rating helps reduce the cost of debt service and makes more projects feasible and cost effective. As the Commonwealth of Kentucky's Budget Reserve Trust Fund has grown from \$2 million to over \$278 million over the past ten years, the Commonwealth's bond credit rating has been upgraded by all three credit agencies and has obtained the highest rating in the state's history, 'AA-' under Standard & Poor's rating definitions, 'Aa3' from Moody's, and 'AA-' from Fitch. While the increases in the BRTF were a significant factor in these rating upgrades, other economic issues and financial management practices contributed as well.

The achievement of receiving a double A rating from all three agencies is an important development for Kentucky. Portfolio managers often require a bond issue to carry a rating of double A before they will consider adding the issue to their investors' portfolios. With this rating, bonds issued by the Commonwealth will enjoy a greater market demand and provide lower costs of borrowing.

Prior to 1966, the Commonwealth of Kentucky relied upon General Obligation bonds, backed by the full faith and credit of the state. The ratings of these bonds reflected the financial strength and stability of the Commonwealth and were based upon the criteria developed and independently judged by each credit agency. The initial rating of Kentucky's General Obli-

gation debt was 'AA' from Standard & Poor's and 'Aa' from Moody's. In 1966, due to the constitutional restriction of requiring voter approval to issue more than \$500,000 in General Obligation debt, the state began a lease appropriation structure where the state uses a lease with the State Property and Buildings Commission (SPBC) subject to biennial appropriations. Moody's and Standard & Poor's both rated the SPBC bonds at 'A', and this rating stayed in place until June of 1999.

The Commonwealth of Kentucky requested a state rating from Moody's to replace the General Obligation rating and received a rating of 'Aa2'. However, Moody's rated the General Fund appropriated credits higher at 'Aa3'. This was significant, as appropriation-supported bonds are normally rated two levels below the rating of the General Obligation issuer. In July of 1999, Standard & Poor's raised the rating to 'A+' and in March 2000 again raised the rating to 'AA-', one level below the state rating of 'AA'. In 1990, the Commonwealth sought a rating from Fitch, one of the newer rating agencies, and received an initial rating of 'A+' for the appropriation-supported bonds. This rating was raised by Fitch to 'AA-' in August of 2000.

KENTUCKY'S CURRENT RATINGS FROM THE MAJOR AGENCIES

Standard & Poor's	AA-
Moody's	Aa3
Fitch	AA-

From the bond rater's perspective, it places a burden on those few states who do not have a rainy day fund, or low fund balances, to explain their plans for handling an economic slowdown. The rating agencies' concern is that the basic public purposes of state government will be curtailed during an economic downturn to the long-term detriment of the state, including its willingness and ability to pay all of its financial obligations.

Bond rating agencies, and others, review carefully the management decisions made by public entities to carry out their programs and purposes. While there are important differences in approaches to delivering public service, rating analysts look for common themes, especially with respect to financial matters and debt obligations. One such theme is a state's preparation for coping with the variability of operating in the dynamic and global economy of today.

Rating agencies, the National Conference of State Legislatures, and other states, acknowledge that a Rainy Day Fund equal to five percent of the general fund budget is a prudent level to put aside for an economic downturn. As bond ratings have increased for some states and all states have enjoyed lower interest rates, the states have been able to borrow more for less. As the economy continues to cool from the unprecedented pace of 1997 through 2000, the cost of debt service for capital expenditure projects can be expected to increase, all else being equal.

Trends in State Bond Credit Ratings

The overall ratings of the fifty states' bond issues has remained virtually unchanged since the end of 1998. This is in spite of the highest general fund balances of the last 20 years, strong state income growth, and only a slight increase in per-capita debt levels. While some states, like Kentucky, have seen rating movement into the 'AA' and 'AAA' categories after the 1991 recession, most of these improvements were completed by the mid-1990s and has not since shown much change.

What has changed are dramatic, largely unexpected, increases in state fund balances. States increased their unreserved general fund balances, along with budget stabilization funds

outside of the unreserved general fund, a median of 25.4% between 1996 and 1999, according to newly released audited information for fiscal 1999 compiled by Standard & Poor's. This begs the question of why there has been very little rating movement given such strong improvements in state fund balances.

The major reason, and cause for future concern, is that the increase in revenues that the states have enjoyed recently have been largely unexpected windfalls, derived from the top tax bracket's non-wage income, especially capital gains dividends. This combination of increased tax revenues and low interest rates has led to a near doubling of net tax-supported debt nationally, from \$100 billion in 1992 to \$200 billion in fiscal 2000. (Standard & Poor's, 2000) State budget expenditures have been rising to keep pace with the increased revenues.

In addition, the future stream of revenues will be reduced as the economy weakens and the permanent tax cutting measures which have been enacted in recent years continue to reduce net flows of revenues to states. The level of permanent and temporary tax cut initiatives now exceed \$50 billion nationwide. In Kentucky, through fiscal year 2001, the total level of tax reduction measures is over \$1.3 billion. Nationwide, these tax cutting measures have been coupled with decreases in state spending on social programs, as a healthy economy reduced welfare rolls by nearly fifty percent and Tax Assistance for Needy Families by 55 percent. (Petry, 2001) However, a slowing economy can be expected to require increased expenditures in the future.

Secondly, states that have heavy manufacturing bases are at the greatest immediate risk. The closing or idling of plants and the accompanying layoffs will reduce personal income tax revenues, sales tax revenues, and lead to increased expenditures for unemployment benefits.

***Top Fifteen Manufacturing States and Rainy Day Funds as a
Percentage of Revenues for FY 2001***

<i>Michigan</i>	<i>12.81%</i>
<i>Indiana</i>	<i>5.85</i>
<i>Wisconsin</i>	<i>No Fund¹</i>
<i>Ohio</i>	<i>5.00</i>
<i>North Carolina</i>	<i>1.13</i>
<i>Arkansas</i>	<i>No Fund²</i>
<i>South Carolina</i>	<i>2.78</i>
<i>New Hampshire</i>	<i>1.85</i>
<i>Kentucky</i>	<i>3.61³</i>
<i>Iowa</i>	<i>9.98</i>
<i>Mississippi</i>	<i>6.87</i>
<i>Pennsylvania</i>	<i>6.02</i>
<i>Tennessee</i>	<i>2.53</i>
<i>Minnesota</i>	<i>8.99</i>
<i>Alabama</i>	<i>0.09</i>

1. Projected year-end balances in General Fund of 1.7% of Revenues.

2. Projected year-end balances in General Fund of 0.0% of Revenues.

3. Prior to budget reductions in FY 2001

Sources: Bureau of Economic Analysis; Department of Commerce, 2000. NCSL, 2000.

With manufacturing's strong presence in the Great Lakes and the Southeast it is important to note the level of reserve funds available to states in these areas. As noted in Attachment 1, Indiana, Michigan, and Ohio all have reserve levels at or above 5%. Most states in the Southeast, however, including Kentucky, are below the 5% level. While the traditional manufacturing industry of the Southeast has been the ever declining textile industry, there has been a great expansion of automobile manufacturing in the region, an industry often first to contract in an economic slowdown.

To emphasize the need for the Budget Reserve Trust Fund, it should be remembered that in 1994 Kentucky faced its largest budget cutback due to a General Fund revenue shortfall of \$264 million. Only recently, after a long stretch of prosperous times and conscientious savings, had the Budget Reserve Trust Fund grown to a level that would cover such a shortfall.

Consolidated Budget Shortfall Data by Fiscal Year

Fiscal Year	General Fund Appropriation Reductions	Non-General Fund Actions	Sum of Actions	Sum of Actions as Percentage of Revenues
80-81	\$64,083,900	\$49,916,100	\$114,000,000	6.02%
81-82	236,608,300	41,100,000	277,708,300	13.23%
82-83	59,850,000	72,320,400	132,170,400	5.99%
83-84	134,171,400	160,332,974	294,504,374	12.46%
86-87	75,143,500	45,337,700	120,481,200	4.19%
87-88	100,026,100	83,463,400	183,489,500	6.06%
91-92	149,054,000	14,798,200	163,852,200	3.76%
92-93	57,072,119	12,547,895	69,620,014	1.54%
93-94	228,060,800	97,871,400	325,932,200	7.01%
00-01	121,119,473	64,280,427	185,399,900	2.68%
01-02	263,594,676	63,128,124	326,722,800	4.48%

Kentucky's General Fund growth began to slow noticeably in the fall of 2000. The sales and use tax, which should have grown rapidly in fiscal year 2001 due to an expansion of the base, instead performed poorly and did not meet expectations. This had been masked due to rapidly rising individual income tax receipts, but as the economy suddenly began to decelerate, income taxes, both personal and corporate, joined the sales tax in failing to reach forecasted levels. By last winter, it became apparent that the General Fund was unlikely to reach the original forecasted level, and the official consensus revenue estimate was adjusted downward twice, by a combined total of \$160 million for fiscal year 2001. In April and June of 2001, General Fund Budget Reduction Orders were issued reducing the Budget Reserve Trust Fund by \$38.8 million and leaving a balance of \$240 million or 3.6 percent of the June 30, 2001 General Fund revenues. Furthermore, downward revisions for fiscal year 2002 reduced expected revenues for the current fiscal year by \$295 million.

Kentucky is not alone in having to adjust to revenue shortfalls. Unfortunately, the current economic downturn has affected Midwestern and Southeastern states most heavily. Sandwiched in between the two groups, Kentucky has likewise seen its economic performance undermined by a slowing national economy. The current fiscal year has at least 20 states besides Kentucky taking extraordinary steps to balance their budgets. Even the federal government is not immune, as projections of future surpluses are disappearing as the economic situation worsens.

For fiscal year 2001, several states tapped Rainy Day Fund balances to deal with budgetary stress. North Carolina used \$157 million from their reserves in addition to using reserves from their capital reserve fund. Oklahoma, which had \$158 million in their Constitutional Reserve Fund, will have again tapped their reserves in FY2001. Mississippi has already used \$15 million in reserves this fiscal year, and has authorized the Governor to use up to \$35 million more if necessary. In Washington, rising Medicaid expenses have caused reserves to be tapped and the state foresees needing to further utilize reserves to alleviate education overruns due to under-estimation of kindergarten through twelfth grade enrollment. Finally, Colorado plans to borrow from a maintenance trust to ensure adequate levels of funding are available to complete planned highway projects.

CHARACTERISTICS OF RAINY DAY FUNDS

The key differences across the states' rainy day funds concern the deposit of funds into the accounts, the limits on the size of the funds, and the circumstances under which the funds may be withdrawn. (Note Attachment 2)

Some states statutorily require deposits to their rainy day fund. States such as Massachusetts require the deposit of all fiscal year surpluses to the fund, while others, like Indiana, determine their deposits by a formula based on the performance of the state economy. The most stringent states only deposit funds by legislative appropriation.

Most states set limits to the size the fund may achieve, as a percentage of revenues. These limits range from as small as two percent to as much as twenty-five percent in Michigan. The most common is five percent, the level suggested by the National Council of State Legislatures. Nineteen states have no limit to the size of their rainy day funds.

Finally, funds differ in the availability of the balances for expenditure. The least stringent requirements for withdrawal are simple appropriations by the legislature. Many states require the existence of budget deficits or revenue shortfalls. The most restrictive rules are those of states, such as Arizona, that require the use of formulas to determine if the state is in a period of economic recession.

ALTERNATIVES FOR REPLENISHING THE BUDGET RESERVE TRUST FUND

Several alternative methods exist for replenishing Kentucky's Budget Reserve Trust Fund. These alternatives will be outlined below with a brief description of the advantages and disadvantages of each. A meaningful public policy option for replenishing the Budget Reserve Trust Fund may require a combination of these alternatives.

1) Allocation from Surplus Expenditure Plan

One of the methods utilized to build Kentucky's Budget Reserve Trust Fund to its historically high level prior to the current revenue shortfall was the allocation of surplus funds to the Budget Reserve Trust Fund. That is, at the conclusion of the fiscal year, a portion of any surplus or undesignated fund balances have been allocated to the Budget Reserve Trust Fund. In the 1998 Surplus Expenditure Plan that was included in the Appropriations Bill, each surplus dollar was allocated on a percentage basis to different uses, including school technology projects; statewide technology projects; community development projects; and, the Budget Reserve Trust Fund. In the 2000 Surplus Expenditure Plan included in the Appropriations Bill, a "priority listing" was established for the use of any surplus funds. The first call in the "priority listing" for the fiscal year ended FY2000 was to fully fund "Bucks for Brains," (\$9 million); the

second call was the replenishing of the Appropriations Not Otherwise Classified (ANOC) account; the third call was appropriations to various emergency repair and replacement accounts; and the final call was to the Budget Reserve Trust Fund. These allocations of surplus funds were successful in building the Budget Reserve Trust Fund from \$200 million to \$279 million.

The downside of this alternative is that surpluses are unpredictable and uncertain. In fact, it is a budget shortfall caused by a weakening economy that requires the utilization of the Budget Reserve Trust Fund. A strengthening economy that grows beyond the projections of the Consensus Forecasting Group may not exist for several years, during which time the Budget Reserve Trust Fund remains at inadequate levels per the guidelines of the bond rating companies.

Still, it has been common practice for the Appropriations Bill to contain a Surplus Expenditure Plan that designates a portion or all of any surplus that might exist to be credited to the Budget Reserve Trust Fund.

2) Direct Appropriation

A direct appropriation to the Budget Reserve Trust Fund in one or both years of the biennium indicates the most significant commitment of state policy makers to the replenishment of the Budget Reserve Trust Fund. The bond rating companies have established a five percent guideline as an appropriate level for the Budget Reserve Trust Fund. This guideline has been noted by the Kentucky General Assembly over time as an appropriate goal for the funding of Kentucky's Budget Reserve Trust Fund.

Therefore, given that the current level of the Budget Reserve Trust Fund is less than the five percent goal, the General Assembly could appropriate the difference between the targeted amount needed to reach the five percent goal and the existing Budget Reserve Trust Fund level over the two years of the biennium. This would require an appropriation each year of the biennium of approximately \$115 million. Such a direct appropriation would be viewed as a strong commitment of Kentucky policy makers to this important financial management principle.

On the other hand, the fiscal reality is that it will be impossible to afford a \$115 million cash appropriation to the Budget Reserve Trust Fund in each year of an upcoming biennium. The General Assembly, as a matter of policy, could reestablish the target goal of five percent with an objective of making direct cash appropriations over a longer period of time; say, five years, to reach this goal. That is, the General Assembly could appropriate approximately \$50 million in each year of the upcoming biennium and indicate its intention to appropriate like amounts (inflated for increases in the state budget) in future biennia.

The fiscal reality of this approach is more feasible, although it is understood that one session of the General Assembly cannot constitutionally commit future sessions of the General Assembly to budgetary actions. Still, the credit markets fully understand Kentucky's biennial budget process and the strong credit quality of Kentucky is based on the biennial appropriation of debt service biennium after biennium. A strong statement of intent in the Appropriations Bill would establish an expectation of such future appropriations.

3) Allocation of "Lapsed" Debt Service

A fundamental principle of a strong financial management program is a consistent investment in capital infrastructure. Much of Kentucky's infrastructure is financed in the capital markets through the issuance of tax-exempt municipal bonds, since Kentucky, like other municipal issuers, is subsidized by the federal government in its financing of capital projects.

In the budget preparation process, an interest rate assumption must be made for the

borrowing cost on capital projects to be financed in the upcoming biennium. Historically, the Commonwealth has utilized the interest rate outlook of a national forecasting service such as Data Resources Inc. (DRI). Given the time horizon and the uncertainty in the capital markets, this interest rate outlook is inflated by a factor to represent the probability that interest rates may increase from the time the budget is prepared through the end of the biennium (thirty months into the future). If the Commonwealth is able to finance its future debt at an interest rate lower than the interest rate used in the debt service assumptions, there is a debt service savings; a savings which will lapse to either the state surplus or be applied to help cover a budget shortfall.

In addition, there may be some capital projects approved by the General Assembly for bond funding in the biennium, which are not ready to be financed during the biennium. The capital construction timeframe of planning and design, acquisition of property and right-of-way, and construction, can be long and unpredictable. Therefore, debt service that may have been appropriated for a project may not be needed in the biennium for which it was first appropriated. Again, this debt service would then lapse to the credit of a General Fund surplus or would be available to cover revenue shortfalls.

The Commonwealth has a professional and aggressive debt management program that aggressively manages the liabilities of the Commonwealth. A major component of liability management is taking advantage of refunding opportunities when they exist. That is, the state, like a homeowner, has the opportunity to refinance outstanding higher interest rate bonds with new lower interest rate bonds and realize savings if such opportunities exist in the marketplace. Such debt service savings would be a potential source of debt service lapse during a biennium. (It should be noted that the Tax Reform Act of 1986 limits the number of times an issuer may undertake an advance refunding; there are no limitations on a current refunding. Further, the Commonwealth has aggressively refinanced outstanding debt and the opportunities to utilize debt service lapses. As a result refunds in the future will be limited.)

Finally, a significant EMPOWER Kentucky initiative was the enactment of House Bill 5 during the 1997 Extraordinary Session of the Kentucky General Assembly. This legislation expanded both the asset and liability management tools available to the Commonwealth. One of the tools that the Commonwealth now may utilize is interim borrowing for construction projects. That is, prior to House Bill 5, the Commonwealth was required to issue long-term fixed-rate bonds to provide the cash needed for the planning and design, property acquisition and right-of-way acquisition, and construction of a project. As soon as the long-term bonds were issued, the Commonwealth was required to begin paying debt service at the long-term fixed-rate borrowing cost. With the enactment of House Bill 5, the Commonwealth may now borrow on an interim basis. That is, if the Commonwealth has a need for funds during planning and design of \$1 million project, it can borrow short-term, taking advantage of the short end of the yield curve. Then, as funds are needed for property acquisition and right-of-way acquisition, a second tranche may be issued; again borrowing less than the full amount of the capital project and financing these costs on the short end of the yield curve. Once the project is complete, the Commonwealth undertakes the long-term, permanent financing. This ability to interim finance provides the opportunity to save significant debt service during construction and these savings have played a key role in allowing the Commonwealth to balance the budget during the recent shortfalls by generating opportunities for lapsed debt service.

Each of the above represents opportunities for the state to realize debt service savings; hence, debt service lapses. Historically, such lapses have become part of a surplus in those years in which revenues exceed expenditures; such lapses have been part of the bal-

ancing strategy in those years for which revenues have not met the estimates. The advantage of "earmarking" debt service lapse is that these funds would go immediately to the Budget Reserve Trust Fund and would not be used for other purposes or shared in the allocation of surplus funds. Further, while there is significant interest rate uncertainty, predictions can be made of the potential magnitude of lapse to provide some comfort that, in fact, some replenishment of the Budget Reserve Trust Fund will take place.

4) Allocation of Investment Income

The Commonwealth aggressively manages its assets, including temporary cash balances. Temporary General Fund cash balances are invested to the credit of the General Fund and are identified as a revenue source to be appropriated as any other General Fund revenue source, (e.g., individual income tax receipts; sales tax receipts; etc.).

A number of other funds also have temporary cash balances that are invested. In some cases, the investment income accrues to the General Fund; in other cases, the investment income accrues to the credit of that particular fund.

For example, temporary cash balances in the Road Fund earn interest income which accrues to the credit of the Road Fund. The Capital Construction Fund (02 Fund), the Trust and Revolving Funds (13/14 Funds), earn interest income on their temporary balances which accrues to the credit of the Capital Construction Fund, used as a cash fund source for capital projects, particularly maintenance projects. A forecast of the potential interest income to be earned on these funds is made as part of the budget process and projects are identified for funding from this fund source. If investment income should exceed the estimate, the Administration has the statutory authority to allow the funds to accrue to the credit of the Capital Construction Fund for appropriation in future sessions, or to be transferred to the General Fund to be applied toward a budget shortfall.

An option for building the Budget Reserve Trust Fund would be to allocate investment income on non-General Fund accounts to the Budget Reserve Trust Fund. For those funds which have the statutory authority to retain earned investment income, a statutory change would be required. It must be remembered that, in the budget, "money is money," and investment income earned to the credit of another fund that is redirected to the Budget Reserve Trust Fund is money that can no longer be used for the purposes that it was previously used. That is, with many agencies, investment income is an agency receipt that often provides significant budget flexibility beyond that provided by the General Fund appropriation. In a budget shortfall, these agency receipts are often transferred to the credit of the General Fund and this alternative for replenishing the Budget Reserve Trust Fund would clearly articulate the use of these monies for purposes other than the use by the agency.

In addition, the Budget Reserve Trust Fund could be created as a separate non-General Fund account with the ability to retain interest income earned to the credit of the Budget Reserve Trust Fund. Again, currently this interest income is accruing to the credit of the General Fund and is hence part of the overall General Fund revenue base. However, earmarking the interest income on the Budget Reserve Trust Fund delineates a discipline for replenishing the Budget Reserve Trust Fund over time, as well as further segregating the Budget Reserve Trust Fund as a separate fund and account of state government. Currently, the Budget Reserve Trust Fund contains \$120 million and, at five percent interest earnings, this would yield \$6 million per year. This is a small annual increment to the Budget Reserve Trust Fund, but for the reasons stated above, deserves consideration as a policy option.

As with many of the other alternatives stated above, the downside of the crediting of investment income or a portion of this investment income to build the Budget Reserve Trust

Fund is the redirection of these resources from other current uses. A policy decision must be made as to what is the most important budget priority and if replenishment of the Budget Reserve Trust Fund is a high priority, then this option has merit.

5) Borrowing

The Budget Reserve Trust Fund was built to its highest balance of \$279 million over a number of years, going back to the early 1990's. It might be financially impossible to expect to rebuild the Budget Reserve Trust Fund to its previous level or to a five percent goal in a short period of time. Yet, one alternative for doing so is to borrow; use the proceeds of the borrowing to replenish the Budget Reserve Trust Fund; and then to repay the borrowing over some period of time, say five to seven years, in recognition of the fact that this was the approximate time frame for originally building the Budget Reserve Trust Fund.

It might be argued that this is not an appropriate use of borrowing, however, the Budget Reserve Trust Fund is an asset of the Commonwealth and borrowing represents creating a liability equal to the asset being created. This is not unlike the Commonwealth's other uses of debt, incurring liabilities, to create assets, be they roads, school buildings, university facilities, or potentially, the "Bucks for Brains" program. The advantage of a borrowing program is that it gets the state to a targeted Budget Reserve Trust Fund level more quickly than other alternatives and it forces a direct appropriation of cash on an annual basis to pay debt service and retire the bonds issued. That is, as noted earlier, one means of building the Budget Reserve Trust Fund is the use of direct appropriations over a period of time. However, politically, it may be difficult to directly appropriate cash when there are other competing programmatic needs. The issuance of bonds would be incorporated into the Commonwealth's overall debt capacity analysis, whereby an affordable level of debt service is identified for budget purposes. A portion of this debt service would then be utilized to meet the debt obligations for the borrowing undertaken to increase the size of the state's asset – the Budget Reserve Trust Fund. The only financial cost to the state would be the cost of issuance in incurring the bonds and the foregone opportunity to use the debt capacity consumed by the Budget Reserve Trust Fund borrowing for other infrastructure purposes.

MOVING FORWARD

Each of the above represent alternatives for committing to the replenishment of the Budget Reserve Trust Fund. As is most often the case with public policy decisions, there is no readily identifiable "right" solution. However, the Commonwealth must develop a credible strategy to replenish the Budget Reserve Trust Fund and maintain the integrity of the state's capital and debt management programs, and hence, the overall financial management programs of the Commonwealth.

To emphasize the importance of replenishing the Budget Reserve Trust Fund and maintaining our 'AA' debt rating, one should note the following quote from Standard & Poor's "Kentucky: Tax Secured General Obligation Credit Profile" (July 20,2001).

"The stable outlook reflects S&P's expectation that the Commonwealth will balance its FY 2002 finances without use of additional reserves and that the Commonwealth will further stabilize revenues by adopting a 2003-2004 biennial budget without continued reliance on one-time revenues. Failure to achieve either of these objectives would place further strain on the Commonwealth's only liquidity and could pressure credit quality." (Emphasis added.)

RECENT ACADEMIC ANALYSIS OF THE EFFECTS OF STATE RAINY DAY FUNDS

Scholarly studies have shown that states that establish rainy day funds tend to be subject to reduced fiscal stress during a recession and enjoy smoother business cycle fluctuations. While this would suggest that rainy day funds have aided states' fiscal health, it *could be* that these states are inherently prudent savers, and would be able to avoid fiscal stress without the establishment of special reserve accounts.

It is important to understand the long-term effects of maintaining a rainy day fund. The mere existence of a rainy day fund does not necessarily imply an increase in government savings. Rainy day funds and general fund balances may be fungible substitutes and increases in rainy day funds may only represent decreases in unrestricted general fund balances.

Statistical analysis of the states and their governments over the period of 1984 to 1999, during which twenty-eight states adopted rainy day funds, gives evidence to support the conclusion that rainy day funds are not simply a substitute for general funds. Rainy day funds have grown across states in terms of both dollar amounts and as a percentage of state revenues, indicating that total savings have increased above the level that would be expected with the increase in state revenues in isolation. The conclusion drawn from these results is that rainy day funds have lead to increased savings above and beyond that which states would have accomplished without the establishment of such accounts. (Sobel and Holcombe, 1996) (Knight and Levinson, 1999)

However, comparing the states in aggregate does not allow for the possibility that states establishing rainy day funds may be different from other states in their ability and willingness to save. In addition, rather than rainy day funds leading to increased savings, it might be that states planning to save establish these funds as a way to fully commit to their savings goals.

The analysis of Dr. Brian Knight and Dr. Arik Levinson from the University of Wisconsin at Madison, controls for per-capita income, state unemployment rate, per-capita government expenditures, legislative party control variables, and state governor's political party affiliations.

Their results were as follows:

- States which started their rainy day funds before 1985 have had significantly larger levels of savings than other states.
- The four states that still do not have rainy day funds have had lower per-capita income, higher rates of unemployment, and lower per-capita government expenditures.
- The more strict the deposit requirements for the fund, either through savings formulas or the requirement of depositing fiscal year end surpluses, the larger the balance of the rainy day fund as compared to those funds which require deposits only through appropriation.
- States that have larger balance limits, especially those states with no limits, save significantly more than those states with limits less than five percent.
- States that limit access to the withdrawal of reserve funds in times of recession, as determined by a formula measuring the business cycle, save more than states that allow access through legislative appropriation.
- States with rainy day funds not only save more than states without, they save even more than they did before the established the rainy day und. The establishment of rainy day funds would seem to alter states' fiscal policies.

CONCLUSION

Rainy day funds provide a formal plan for dealing with revenue shortfalls rather than forcing ad hoc methods such as across the board appropriation cuts, delays in spending, or deferrals of obligations. Rainy day funds do not take the place of budgetary discipline, they only provide the time necessary to make reasoned choices.

Kentucky worked hard over the last decade to build the Budget Reserve Trust Fund to its historically, largest level; yet has had to turn to the fund twice in the current biennium to address budget shortfalls. Kentucky needs to continue striving to reach and maintain the goal of five percent of revenues.

A rainy day fund may reduce the interest the state pays on its bond issues. Bond rating agencies consider states with effective mechanisms for building financial reserves to be exhibiting fiscal discipline and preparedness for dealing with economic downturns.

To preserve the Commonwealth's favorable credit rating and as a matter of policy, any transfers made from the Budget Reserve Trust Fund to facilitate cash flow should be repaid as soon as possible. The use of rainy day funds by states in times of economic downturns is not viewed negatively by the bond rating agencies if the funds are replaced.

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Attachment 1

	Fiscal 1999 (Actual)			Fiscal 2000 (Preliminary Actual)			Fiscal 2001 (Appropriated)		
	Revenues	RDF	As % of Exp.	Revenues	RDF	As % of Exp.	Revenues	RDF	As % of Exp.
<u>New England</u>									
Connecticut	10,616	529	4.98%	11,214	564	5.03%	11,281	565	5.01%
Maine	2,237	132	5.90%	2,395	144	6.01%	2,346	144	6.14%
Massachusetts	19,075	1,389	7.28%	20,437	1,608	7.87%	20,207	1,641	8.12%
New Hampshire	1,024	20	1.95%	1,034	20	1.93%	1,079	20	1.85%
Rhode Island	2,019	65	3.22%	2,243	71	3.17%	2,340	74	3.16%
Vermont	841	40	4.76%	886	41	4.63%	886	43	4.85%
<u>Mid-Atlantic</u>									
Delaware	2,191	114	5.20%	2,279	120	5.27%	2,343	126	5.38%
Maryland	8,513	635	7.46%	9,215	582	6.32%	9,325	916	9.82%
New Jersey	18,164	627	3.45%	19,393	650	3.35%	20,714	650	3.14%
New York	36,741	473	1.29%	37,395	547	1.46%	39,717	547	1.38%
Pennsylvania	18,583	941	5.06%	19,442	1,097	5.64%	19,315	1,162	6.02%
<u>Great Lakes</u>									
Illinois	21,675	0	0.00%	23,250	0	0.00%	24,060	225	0.94%
Indiana	8,940	525	5.87%	9,215	540	5.86%	9,699	567	5.85%
Michigan	9,561	1,223	12.79%	10,035	1,264	12.60%	10,499	1,345	12.81%
Ohio	19,065	953	5.00%	20,051	1,003	5.00%	20,931	1,047	5.00%
Wisconsin	10,114	0	0.00%	11,401	0	0.00%	10,597	0	0.00%
<u>Plains</u>									
Iowa	4,538	444	9.78%	4,734	460	9.72%	4,890	488	9.98%
Kansas	3,978	0	0.00%	4,202	0	0.00%	4,421	0	0.00%
Minnesota	10,374	1,542	14.86%	11,424	1,117	9.78%	12,422	1,117	8.99%
Missouri	7,072	135	1.91%	7,180	143	1.99%	7,426	152	2.05%
Nebraska	2,124	146	6.87%	2,404	142	5.91%	2,479	170	6.86%
North Dakota	740	0	0.00%	771	0	0.00%	814	0	0.00%
South Dakota	751	35	4.66%	782	37	4.73%	797	0	0.00%
<u>Southeast</u>									
Alabama	4,940	0	0.00%	5,235	3	0.06%	5,459	5	0.09%
Arkansas	3,050	0	0.00%	3,177	0	0.00%	3,261	0	0.00%
Florida	17,917	1,328	7.41%	18,593	1,666	8.96%	19,967	1,309	6.56%
Georgia	13,384	381	2.85%	13,208	379	2.87%	14,306	408	2.85%
Kentucky	6,237	230	3.69%	6,718	239	3.56%	6,722	238	3.54%
Louisiana	5,831	24	0.41%	5,930	57	0.96%	6,208	88	1.42%
Mississippi	3,217	225	6.99%	3,433	238	6.93%	3,597	247	6.87%
North Carolina	12,734	523	4.11%	13,136	38	0.29%	13,981	158	1.13%
South Carolina	4,931	138	2.80%	4,999	145	2.90%	5,317	148	2.78%
Tennessee	6,251	127	2.03%	6,764	165	2.44%	7,037	178	2.53%
Virginia	9,708	362	3.73%	11,450	575	5.02%	11,827	678	5.73%
West Virginia	2,618	65	2.48%	2,639	73	2.77%	2,710	79	2.92%
<u>Southwest</u>									
Arizona	5,635	387	6.87%	5,960	408	6.85%	6,110	423	6.92%
New Mexico	2,946	185	6.28%	3,232	187	5.79%	3,342	222	6.64%
Oklahoma	4,506	150	3.33%	4,713	158	3.35%	4,844	158	3.26%
Texas	53,405	80	0.15%	55,674	183	0.33%	NA	NA	NA
<u>Rocky Mountain</u>									
Colorado	5,794	217	3.75%	6,304	227	3.60%	6,695	239	3.57%
Idaho	1,625	36	2.22%	1,708	19	1.11%	1,768	36	2.04%
Montana	1,106	0	0.00%	1,167	0	0.00%	1,139	0	0.00%
Utah	3,191	95	2.98%	3,505	110	3.14%	3,495	116	3.32%
Wyoming	500	13	2.60%	543	10	1.84%	518	8	1.54%
<u>Far West</u>									
Alaska	1,291	2,628	203.56%	1,984	2,889	145.61%	1,854	2,905	156.69%
California	58,615	3,116	5.32%	71,162	7,236	10.17%	73,862	1,782	2.41%
Hawaii	3,286	0	0.00%	3,284	0	0.00%	3,409	0	0.00%
Nevada	1,526	129	8.45%	1,647	129	7.83%	1,623	129	7.95%
Oregon	4,328	28	0.65%	4,949	42	0.85%	5,280	8	0.15%
Washington	9,977	536	5.37%	10,431	759	7.28%	10,699	535	5.00%

Source: State Budget Actions 2000: Special Fiscal Report,

National Conference of State Legislatures

Attachment 2: State Rainy Day Fund Details

State	Deposit method	Limit (as % of expenditures)	Withdrawal method	Year started (first balance)
Alabama	formula	2%	appropriation	1988
Alaska	appropriation	no limit	appropriation	pre-1985
Arizona	formula	5%	formula	1994
Arkansas				
California	year-end surplus	no limit	revenue shortfall	pre-1985
Colorado	formula	2%	revenue shortfall	pre-1985
Connecticut	year-end surplus	5%	revenue shortfall	pre-1985
Delaware	year-end surplus	5%	revenue shortfall	pre-1985
Florida	formula	20%	revenue shortfall	pre-1985
Georgia	year-end surplus	3%	appropriation	pre-1985
Hawaii	formula	no limit	appropriation	2000
Idaho	appropriation	no limit	appropriation	pre-1985
Illinois	formula	4%	appropriation	1999
Indiana	formula	7%	formula	1985
Iowa	appropriation	10%	appropriation	pre-1985
Kansas	appropriation	5%	appropriation	1993
Kentucky	appropriation	5%	revenue shortfall	1987
Louisiana	appropriation	no limit	revenue shortfall	1996
Maine	year-end surplus	4%	appropriation	1985
Maryland	formula	no limit	appropriation	1987
Massachusetts	year-end surplus	5%	revenue shortfall	1987
Michigan	formula	25%	formula	pre-1985
Minnesota	year-end surplus	5%	revenue shortfall	pre-1985
Mississippi	year-end surplus	7.5%	revenue shortfall	1985
Missouri	appropriation	5%	revenue shortfall	1992
Montana				
Nebraska	year-end surplus	no limit	revenue shortfall	pre-1985
Nevada	formula	8%	revenue shortfall	1987
New Hampshire	year-end surplus	5%	revenue shortfall	1987
New Jersey	year-end surplus	5%	revenue shortfall	1988
New Mexico	appropriation	no limit	revenue shortfall	pre-1985
New York	year-end surplus	2%	revenue shortfall	pre-1985
North Carolina	year-end surplus	5%	appropriation	1990
North Dakota	year-end surplus	no limit	revenue shortfall	1989
Ohio	appropriation	4%	appropriation	1985
Oklahoma	year-end surplus	10%	revenue shortfall	1988
Oregon				1994
Pennsylvania	appropriation	3%	revenue shortfall	1986
Rhode Island	appropriation	3%	revenue shortfall	1985
South Carolina	appropriation	5%	revenue shortfall	pre-1985
South Dakota	year-end surplus	5%	appropriation	pre-1985
Tennessee	appropriation	no limit	revenue shortfall	pre-1985
Texas	year-end surplus	10%	revenue shortfall	1990
Utah	year-end surplus	8%	revenue shortfall	1987
Vermont	year-end surplus	5%	revenue shortfall	1988
Virginia	formula	10%	appropriation	1985

Attachment 2: State Rainy Day Fund Details cont'd

Washington	formula	no limit	revenue shortfall	1989
West Virginia	year-end surplus	5%	revenue shortfall	1994
Wisconsin	appropriation	no limit	appropriation	1993
Wyoming	year-end surplus	no limit	appropriation	pre-1985

Source: National Association of State Budget Officers (NASBO). Budget Process in the States. *Washington, DC: NASBO October, 1999.*